

# Trapped Cash in the Manufacturing Sector

East Midlands

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# Management Summary

- Late payments are detrimental to cash flow, which is important for the health of a business as it enables it to make investments, overcome financial challenges and, ultimately, grow.
- Our previous research shows that SMEs are missing out on £250 billion of liquid cash flow because of slow and late payments.<sup>1</sup>
- Late payments are a particular problem for SMEs in the East Midlands. On average firms in the region are made to wait 41 days before they receive their money, four days more than the national average.<sup>2</sup>
- The manufacturing sector in the East Midlands makes a significant contribution to the local economy, accounting for 16.7% of the region's output.<sup>3</sup> Manufacturing is largely made up of SMEs which operate within a complex supply chain involving firms across the UK and the world.
- This paper uses a conservative research model which estimates that £1.5bn could be freed up for SMEs in the manufacturing sector in the East Midlands through the use of invoice finance.
- This significant sum could improve manufacturers' cash flow, be reinvested into the sector and contribute to the success of manufacturing in the region.



# Why is good cash flow important?

Generating positive cash flow is a sign of a company's financial health and means it can settle debts, reinvest in its business, pay expenses and provide a buffer against future financial challenges.<sup>4</sup> Cash flow management is important to any business because ultimately it determines a company's ability to create value for its shareholders.

Businesses can use cash flow to:-

- **Fund new product/service development** – Expanding into new areas requires upfront investment to make it happen
- **Order more inventory or raw materials** – A sudden influx of orders is welcome, but to satisfy them quickly the components need to be purchased
- **Avoid problems with the costs of growth** – Growth brings a number of possible costs including recruitment fees, extra salaries and employee benefits, purchase of materials and equipment, and potentially larger premises all of which need to be covered often before the financial benefits of being a bigger business are realised
- **Reduce the risk and impact of unexpected costs** – Any number of unexpected costs can befall a business. For example, a critical piece of machinery might suddenly fail and need repair or replacement
- **Afford tactical sales initiatives** – Businesses often need to make investments to react to sales opportunities. For example, a competitor might fail or become ineffective and a company might see an opportunity to invest in targeted sales activity aimed at the competitor's customers.
- **Pay for advertising and marketing** – These activities help business to sell more products/services and expand

All of these applications of cash flow have a common aim of helping the company to grow and generate more profit. But they all require investment before that growth is realised. A company with good cash flow has competitive advantage because it is able to deploy funds for upfront investment in these activities. Companies which have poorer cash flow lack the working capital and therefore the resources to achieve these things. Or they may find they can't react to opportunities quickly because they need to keep a tighter rein on their finances in order to pay key suppliers on time.

So it's easy to see why small business owners place a great deal of importance in preserving their cash flow. In fact, over 70% of small business owners agree that poor cash flow poses the greatest risk to their company.<sup>5</sup>

“...over 70% of small business owners agree that poor cash flow poses the greatest risk to their company”



# The impact of late payments – the poor cash flow cycle

Late payments are detrimental to cash flow because not receiving invoice settlements on time means companies have less cash available to them.

38% of UK businesses say that they receive most invoice payments out of terms<sup>6</sup> and our previous research shows that SMEs are missing out on £250 billion of liquid cash flow because of slow and late payments.<sup>7</sup> Late payments cost businesses time and resources to track and chase, but chronic late payments can become a more serious problem and threaten the resilience of the business. Around 50,000 businesses fail each year due to late payments and this amounts to a £2.5bn shortfall for the UK economy to withstand.<sup>8</sup>

We've already seen that cash flow can be used to fund activities that contribute to company growth. In addition, good cash flow management allows a business to build up a 'float' to cover payments before they arrive. Even a timely payment will come 30, 60 or 90 days after the product or service is delivered, depending on the terms. The longer payments take to arrive, the more of a cash 'float' a company needs, but the less cash they have available. Therefore, an increasing proportion of the business' cash is tied up 'plugging' the payment gap and is unavailable to invest in fostering growth.

# Cash flow in the East Midlands

There are 163,000 SMEs in the East Midlands,<sup>9</sup> many of which are in the manufacturing sector. SMEs are vital to UK manufacturing which operates within a highly complex supply chain. Nationally, the vast majority of manufacturing companies are small businesses.<sup>10</sup>

There are 367,000 SMEs in the East Midlands,<sup>9</sup> many of which are in the manufacturing sector. SMEs are vital to UK manufacturing which operates within a highly complex supply chain. Nationally, the vast majority of manufacturing companies are small businesses.<sup>10</sup>

The East Midlands has the second highest proportion of manufacturing output within the UK, after Wales, accounting for 16.7% of the region's non-financial business output.<sup>11</sup> Although uncertainties around the UK's relationship with the EU remain, global companies from sectors including food and drink; transport equipment; rubber; plastics and non-metallic minerals have all invested in the region.<sup>12</sup>

The transport equipment manufacturing sector, for example, accounts for 15% of manufacturing activity in the East Midlands, employing over 26,000 people and generating around £2.4 billion of gross value added (GVA) per year.<sup>13</sup> Similarly, its thriving aerospace sector continues to boost the region's economy given the insatiable demand for air travel, with the area accounting for 20.3% of all aerospace employment in the UK.<sup>14</sup>

The East Midlands also plays an important part in the food and drink manufacturing sector. The region employs over 58,000 people in the industry, producing £3.8bn of GVA for the economy and exporting £1.0bn of food and drink products in 2017.<sup>15</sup>

However, despite the important role SMEs play in the region's economy, when it comes to small business performance, the East Midlands falls behind some other regions. While London and the South East perform well above the overall UK average, manufacturing productivity for East Midlands firms is 87.3% of the UK average, which is the lowest result in the UK.<sup>16</sup>

Perhaps one contributory factor is that the East Midlands has one of the highest proportions of SMEs suffering cash flow issues at 67%,<sup>17</sup> making it the third worst region for late payments in the UK.<sup>18</sup> Research shows that businesses in the East Midlands of England are taking, on average 41 days to be paid, four days more than the national average.<sup>19</sup>

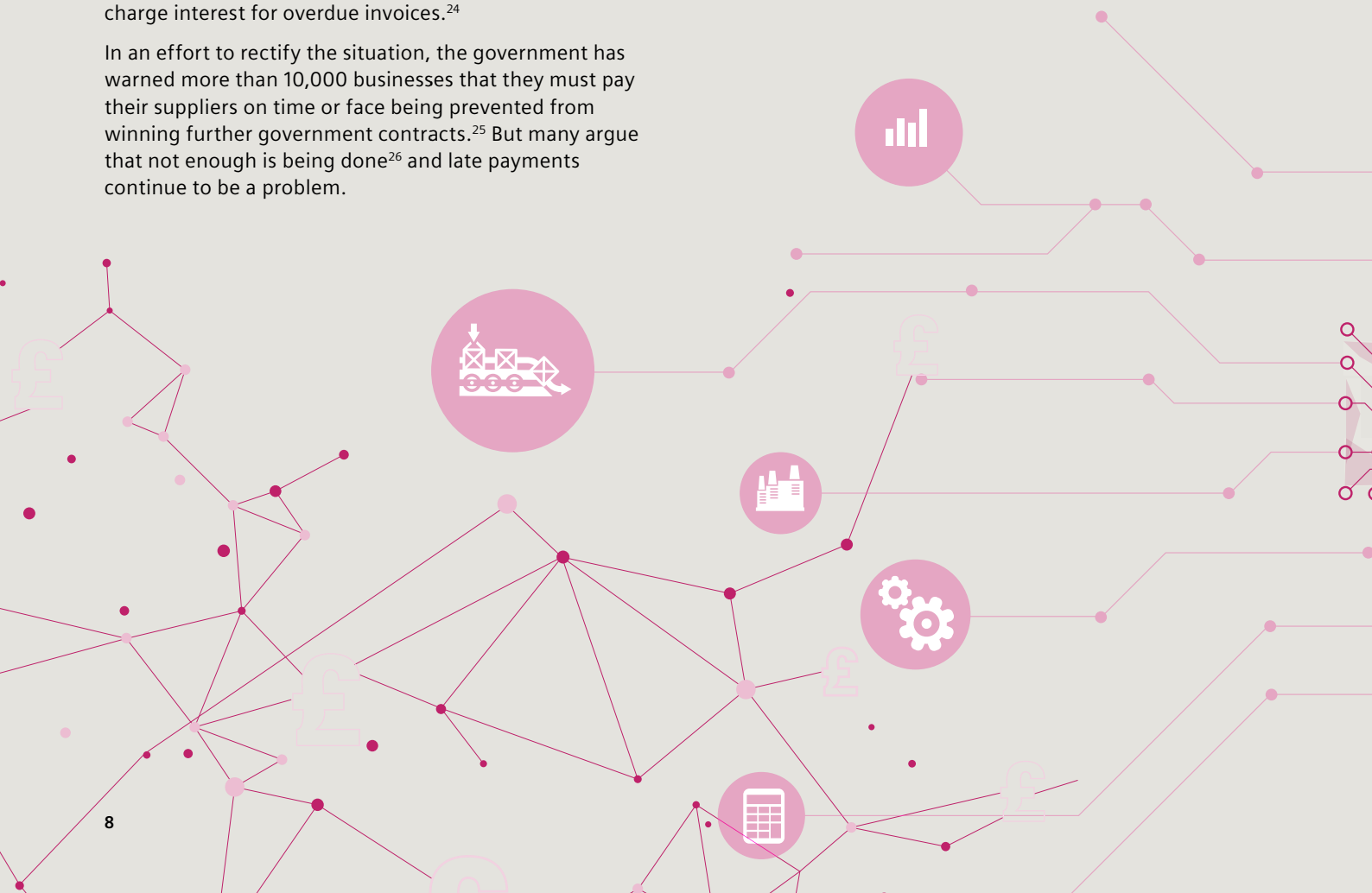
# Invoice Finance as a cash flow enabler

SMEs need to be paid on time in order to maintain their cash flow. However, despite repeated calls for invoices to be settled more promptly,<sup>20</sup> businesses – and particularly SMEs – still suffer from the effects of late payments.

As a result, 37% of small businesses run into cash flow difficulties, 30% have been forced into taking out an overdraft, while 20% suffered a slowdown in profit growth as a result.<sup>21</sup> Manufacturing is a sector that operates on tight profit margins; an average of 15.7%<sup>22</sup> and in a survey by The Manufacturer, 40% of manufacturers said they were unsure of where their future profits would come from.<sup>23</sup> Furthermore, 61% of small businesses are paid late by big businesses, but conversely, 79% of small businesses don't charge interest for overdue invoices.<sup>24</sup>

In an effort to rectify the situation, the government has warned more than 10,000 businesses that they must pay their suppliers on time or face being prevented from winning further government contracts.<sup>25</sup> But many argue that not enough is being done<sup>26</sup> and late payments continue to be a problem.

Therefore, many SME manufacturers are turning to invoice finance to bolster their cash flow. By using invoice finance, when a company invoices their customer, up to 90% of the approved invoice total is immediately advanced by the finance provider, with the remaining 10% paid once their customer settles the balance. This provides the company with essential working capital so it can then invest in expanding its business without having to wait for bills to be paid.





Invoice finance continues to grow in popularity; 21% of UK businesses with a turnover over £1m per year use invoice finance.<sup>27</sup> The tool is becoming particularly important to the manufacturing sector with manufacturers accounting for 25% of companies using invoice finance.<sup>28</sup>

As we've seen, manufacturers play an important role in the economy of the East Midlands. It's therefore important that these businesses receive the financial support that enables them to grow and continue to contribute to the prosperity of the region.

Siemens Financial Services has calculated how much cash could be freed up for the manufacturing sector in the East Midlands through the use of invoice finance. By taking the average manufacturing DSO and applying this to the turnover of manufacturers in the region we can estimate the value of payments left outstanding. The proportion of companies not eligible for invoice finance has then been removed. This figure is then multiplied by 90% for the amount advanced through invoice finance, and halved to eliminate any exaggeration due to, for example, ineligible invoices and current invoice finance marketing penetration.

Based on this conservative model, £1.5bn could be freed up for SMEs in the manufacturing sector in the East Midlands through the use of invoice finance.

# Conclusion

Manufacturing is an important sector to the East Midlands. The vast majority of these manufacturers are SMEs all of which have an important role to play in the complex supply chain of the sector, not just in the local region but nationally and internationally.

Good cash flow is important for any business, but particularly for SMEs which lack the capital resources of their larger counterparts and often operate on tight margins. It's long been acknowledged that late payments cause a significant problem for SMEs but those awaiting a solution have been left wanting.

By utilising invoice finance, SME manufacturers in the East Midlands of England can access the cash flow needed to develop new products, approach new customers and ensure they have the resources available to meet any unforeseen costs. As this research shows, the sums available to the manufacturing sector in the East Midlands through invoice finance are considerable. By freeing this 'trapped' cash, SMEs can look forward to realising their growth ambitions and further contributing to the economy.

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Updated (unless stated otherwise): September 2019

